

GOVERNANCE NOTES

CUSTOMS REFORM AND PERFORMANCE CONTRACTS: EARLY RESULTS FROM MADAGASCAR

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Malagasy customs introduced performance-based pay for customs inspectors in Madagascar's main port of Toamasina, incentivizing them to curb tax evasion and illicit financial flows, and expedite customs clearance.¹ While performance pay has been associated with positive outcomes in education, health, and tax collection when objectives are clearly defined (Hasnain, Manning, and Pierskall 2014; Prentice, Burgess, and Propper 2007), little is known about its usefulness in motivating customs agents to achieve multiple objectives, including facilitating trade while maximizing revenue collected and minimizing fraud.²

Initial evidence suggests that individual inspector performance contracts improves customs performance and service delivery by reducing clearance times. The reform's success to date reflects effective management in customs, strong support from the Minister of Finance and Budget, extensive stakeholder consultation, application of data mining techniques, more intensive monitoring, and deep collaboration between Malagasy customs and the World Bank. If the early results prove robust, public servant performance contracts could be a cost-effective approach to improving revenue administration and service delivery in other contexts, including fragile countries.

USING HUMAN RESOURCE MANAGEMENT TO IMPROVE PERFORMANCE AND SERVICE DELIVERY

Madagascar, a fragile and fifth poorest country in the world (2015 GDP per capita of \$402), is a valuable context for examining the impact of performance pay on customs operations. With a tax to GDP ratio of 10 percent, the country's revenue mobilization is among the lowest in the world. Customs revenues account for 44 percent of overall tax revenues, despite estimated tariff evasion

revenue losses equal to 30 percent of non-oil revenues (Chalendar, Raballand, and Rakotoarisoa 2016).

Malagasy customs, under the leadership of a new director general, initiated reforms from 2015 to address customs performance, including deep collaboration with the World Bank. The reform did not involve investment in information technology or equipment. Moreover, the World Bank only provided training and analytic and advisory support, including on-site visits to countries with similar systems.

World Bank support included a study of tariff evasion channels using mirror trade statistics (Ibid 2016). Based on this study, the Malagasy authorities identified two priorities: reforming the accelerated clearance program and improving human resource management by introducing performance contracts.

Inspector performance contracts reward good performance with (i) bonuses,³ (ii) training opportunities at home and abroad, and (iii) accelerated career progression. They sanction poor performance by reassigning inspectors to less desirable positions.⁴ The contracts were written after consultations with inspectors and the private sector over several months (from May to September 2016), and contain seven objective indicators covering the speed with which goods are cleared, the efficiency of customs controls, and targets for revenues and fraud detection.

PRELIMINARY LESSONS

Implementing the performance contracts required both a focus on human resource management, and consensus building through stakeholder dialogue. A project implementation unit was established, which was

¹ The reform effort is part of Madagascar's *Public Sector Performance Project* (P150116).

² Political and internal motivations for Cameroon customs inspectors are described by Cantens, Ireland, and Raballand (2012).

³ In addition to merit awards, each quarter the best performer receives a bonus (\$1,000) representing 2.5 times Madagascar's GDP per capita.

⁴ Working in the Toamasina Port is the most attractive position in Madagascar customs as the result of higher opportunities for bonuses from fraud recording. Inspectors get a share of the amount of the recorded fraud.

pivotal to the success of the program. It uses detailed data on import declarations collected from the Automated System for Customs Data (ASYCUDA) to monitor each inspector's performance. Inspectors in Toamasina play a key role in mobilizing domestic revenues. The average customs officer usually collects 1.5 percent of total annual tax revenues each year (about \$1.4 million per inspector per month), but revenues fluctuate as imports vary seasonally.

Setting explicit performance targets required overcoming resistance through consultations and negotiations with inspectors. The implementation unit's approach of structured dialogue, backed by strong support from the director general and the minister of finance and budget, proved successful. Despite initial anxiety, the vast majority of inspectors when surveyed said they preferred performance contracting after being trained on using the new monitoring system. Performance contracts have also enabled better information flow from the ground to the director general and the implementation unit.

Discussions to define the contract between the implementation unit and the inspectors began in May 2016, coinciding with the restructuring of the accelerated clearance program. Performance contracts were eventually signed in September 2016 and entered into force in October 2016. The reform is ongoing and will be evaluated in depth; however, preliminary findings have emerged from ASYCUDA.

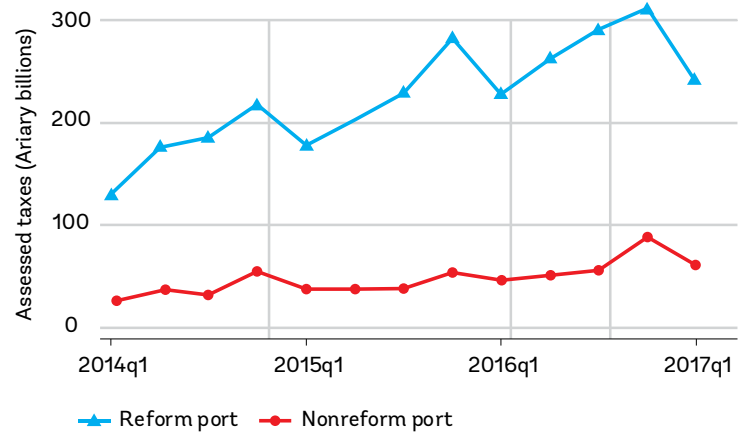
PRELIMINARY RESULTS

Tax revenues grew since the start of the training period. Figure 1a plots the evolution of assessed taxes over time for Toamasina (the reform port) and other seaports (nonreform ports). Vertical lines represent the appointment of the new director general in the first quarter of 2015, the start of the training phase in the first quarter of 2016, and the effective start of the performance contracts in the first quarter of 2017. Tax revenue growth was driven by trade with an increase in the number of import declarations, and greater tax revenue per declaration (see Figure 1b).⁵

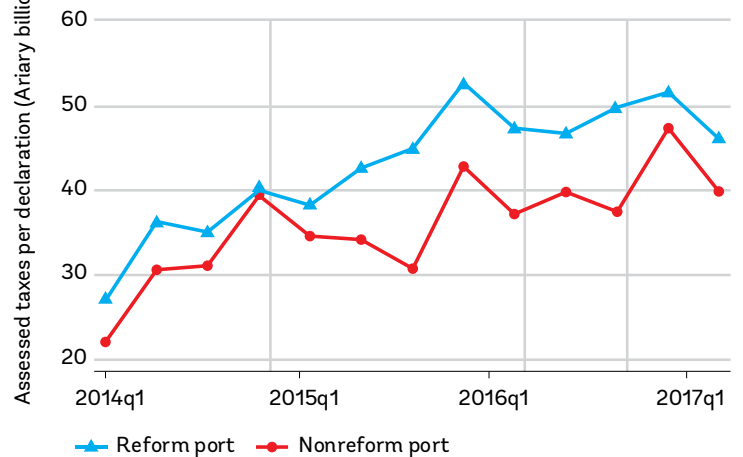
Nonreform ports also collected more taxes, both in total and per declaration (Figures 1a and 1b). Since revenue improvement occurred in both reform and nonreform ports, the change does not appear associated with introduction of performance contracts in Toamasina.

In Toamasina, customs clearance times dropped substantially, but increased in other ports (see Figure 2).

1 a. Assessed Taxes

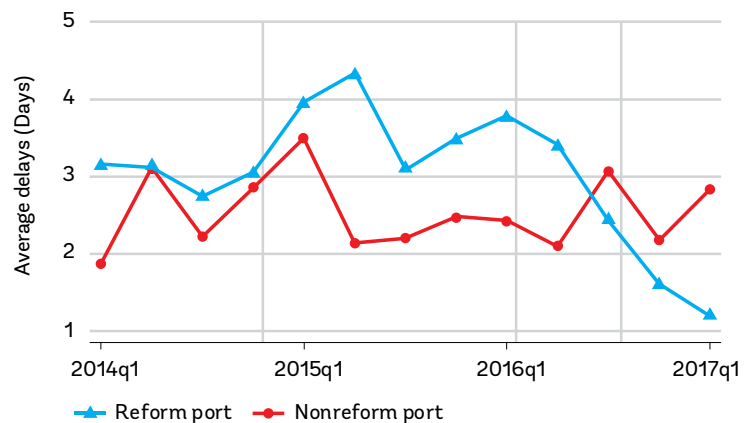


1 b. Assessed Taxes per Declaration



2. Evolution of Average Delays

Average delays: Date of assessment - Date of submission



⁵ To reduce confounding factors during the study period, imports handled by any firm eligible for the accelerated clearance program, are excluded from the sample.

The reduction in clearance times was remarkable and driven both by fewer physical inspections (see Figure 3) as well as expedited inspections and documentary controls. From a trade facilitation perspective, the performance contract reform appears to be successful.

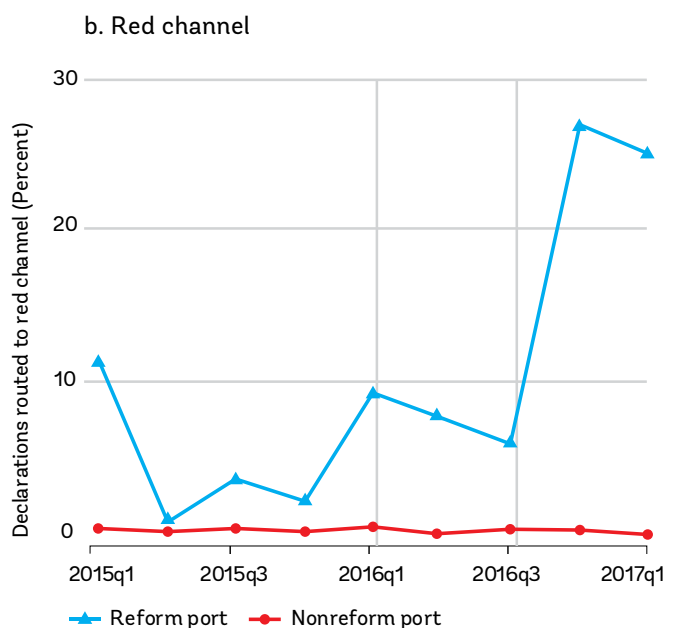
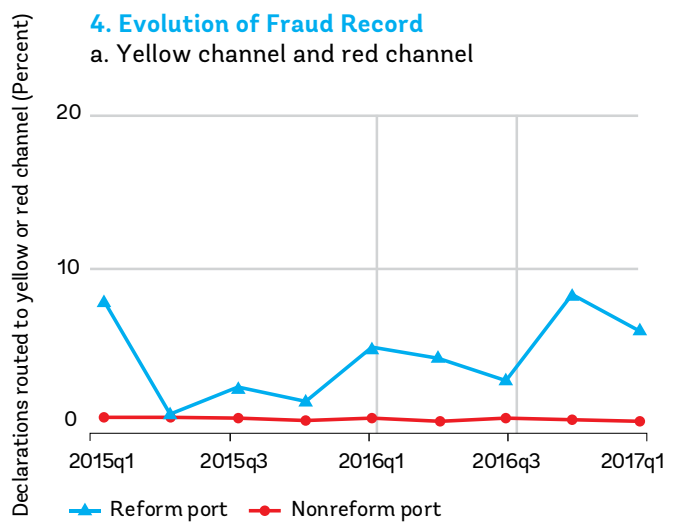
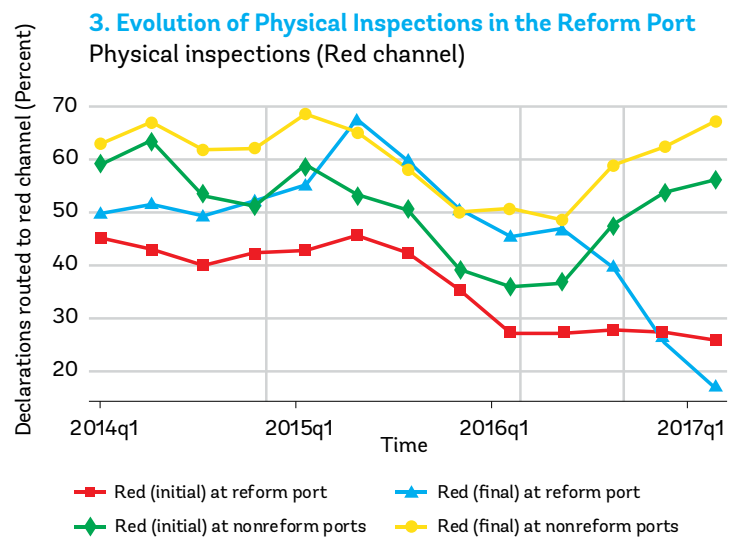
The rate of physical inspections in Toamasina decreased but not in other ports in 2016. The observed sharp decrease in the final allocation to the red channel is due to a change in inspector behavior.⁶ Inspectors utilized the new opportunities offered by the performance contract by (i) “upgrading” fewer declarations from the yellow channel for documentary inspection to the red channel and (ii) by downgrading to the yellow channel more declarations assigned to the red channel.

The reduction in physical inspections coincided with better inspection targeting and more declared fraud.

Figures 4a and 4b plot the evolution of the proportion of declarations reported to be fraudulent in the yellow or red channel, or the red channel, respectively. The introduction of performance contracts—which incentivize fraud recording—was associated with a marked increase in fraud recording in Toamasina, but not in the other ports.

A concern with the current performance contract framework is whether incentives customs officers to extort, act opportunistically, or abuse their increased discretion over which shipments to inspect. While these effects are difficult to assess, consultations with the private sector do not suggest inspectors were overzealous in issuing fines. Some preliminary evidence shows inspectors downgrade (i.e., decide not to inspect) relatively risky declarations. In addition, some observers expressed concerns about collusion between customs brokers and inspectors. Malagasy customs discovered evidence suggesting some inspectors issued fines smaller than the recommended amount (which is a common practice in Sub-Saharan Africa), nominally complying with the performance contract but benefitting non-compliant importers. This finding warrants adjustments in the performance indicators during a second phase of contracts. Certain inspectors are being investigated, and four out of fifteen opted not to sign new contracts in May 2017 despite having met performance targets. One inspector failed to meet targets. In total, five out of fifteen inspectors were replaced.

Sustaining the early successes will require continued surveillance of inspectors and strong management. Some inspectors, importers, and brokers may find



⁶ As a result, the number of inspections strongly declined in Toamasina. A reduction of 60 percent is seen between the third quarter of 2016 and the first quarter of 2017.

ways to manipulate performance indicators. At the same time, publicizing performance metrics and rewarding good performance contribute to a culture of meritocracy and transparency. This is important since only one out of every ten inspectors in Madagascar believe promotions are fair, according to a survey conducted during contract implementation. To be more transparent, a vacancy announcement to replace the five inspectors in Toamasina was published internally to all of the country's inspectors (more than 120), and a panel will select the best five candidates. This type of recruitment is the first of its kind to fill positions in Toamasina. For the fight against fraud, team-based performance contracts have been defined and signed with the headquarters unit.

More generally, the reform serves as a stepping stone toward modernizing customs and revenue administration. For example, the director general of tax administration has expressed interest in experimenting with a similar pay-for-performance scheme for tax inspectors.

CONCLUSION

Malagasy customs piloted the introduction of performance contracts for inspectors to improve revenues, expedite trade, and reduce fraud. While assessing the impact of the reform on customs performance requires more extensive analysis (which the Development Economics Research Group, Trade, and International Integration team and the Governance Global Practice are undertaking), the documented trends suggest the reform has been successful so far.

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It facilitates trade by expediting customs clearance, improves fraud detection, and enhances the efficiency of controls. In addition, despite fewer physical inspections, both the number and the frequency of fraud recording has grown.

With committed government counterparts, the success of this type of contract can be replicated in other settings, including fragile countries, at limited cost. It shows that, despite a fragile country context, revenue mobilization may be improved and frontline officers' behaviors may change if the World Bank builds trust with customs management and tries to tackle concrete customs administration problems.

